Federal Regulatory Relations
1275 Pennsylvania Avenue, N.W., Suite 400
Washington, D.C. 20004
(202) 383-6400

PACIFIC TELESIS.
Group-Washington

DOCKET FILE COPY ORIGINAL

May 17, 1995

RECEIVED
MAY 1 7 1995
FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

William F. Caton
Acting Secretary
Federal Communications Commission
Mail Stop 1170
1919 M Street, N.W., Room 222
Washington, D.C. 20554

Dear Mr. Caton:

Re: *CC Docket No. 94-1 - Price Cap Performance Review for Local Exchange Carriers; Treatment of Video Dialtone Services Under Price Cap Regulation*

On behalf of Pacific Bell, please find enclosed an original and six copies of its *"Reply Comments"* in the above proceeding.

Please stamp and return the provided copy to confirm your receipt. Please contact me at (202) 383-6429 should you have any questions or require additional information concerning this matter.

Sincerely,

Jay Bennett

Jay Bennett

Enclosure

No. of Copies rec'd 0+5
List ABCDE

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

RECEIVED
MAY 17 1995
FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

| | |
|---|---|
| In the Matter of<br><br>Price Cap Performance Review<br>for Local Exchange Carriers;<br>Treatment of Video Dialtone Services<br>Under Price Cap Regulation | CC Docket No. 94-1 |

# REPLY COMMENTS OF PACIFIC BELL

Pacific Bell ("Pacific") hereby respectfully replies to Comments filed in the above-captioned proceeding. In our Comments, we suggested that carriers should be allowed to provide VDT service without price regulation if they elect the no-sharing option under the price cap plan. If VDT is regulated under price caps, the Commission should be careful not to subject it to so much oversight that meaningful competition to entrenched cable television carriers never, or only slowly emerges. VDT service is in its infancy. Conventional price regulation fails to provide the flexibility needed to respond to consumer demands when they are still largely a matter of informed guesswork. Overregulating prices can easily cripple VDT because the value of the network to each subscriber depends so much on the total number of subscribers and providers. A starting price that sends the wrong signals to consumers, then cannot be changed except in small annual increments, may retard the development of VDT and harm consumer welfare.

The California Cable Television Association ("CCTA"), the National Cable Television Association ("NCTA"), Cox Enterprises ("Cox"), the Ad Hoc Telecommunications Users Group ("Ad Hoc"), AT&T, MCI, and others would like the Commission to administer a fatal dose of caution to the potential "outbreak" of VDT. These parties have no interest in VDT succeeding in the marketplace. On the contrary, they know that in the near future the carrier that succeeds will be the one that provides consumers with the greatest combination of services at the most attractive price -- mass media, access to information, telephony without boundaries, and other services not yet dreamed of. In Eli Noam's words, planning for this future requires "an end to the nostalgia for the simplicity of the golden age, a vision of a very different network environment, and the willingness to engage in analysis that goes beyond that of competition versus monopoly, because most future issues cannot be analyzed in such simple terms."[1]

The IXCs and cable companies represent neither the interests of consumers, nor of vigorous competition. They are just incumbent providers in two of the least competitive markets in America today. The Commission should take care not to confuse their interests with those of competition. As Judge (now Justice) Stephen Breyer wrote for a panel of the First Circuit,

> a practice isn't "anticompetitive" simply because it harms competitors. After all, almost all business activity, desirable and undesirable alike, seeks to advance a firm's fortunes at the expense of its competitors. Rather, a practice is "anticompetitive" only if it harms the competitive process. It harms that process when it obstructs the achievement of competition's basic goals -- lower prices, better products, and more efficient production methods.[2]

---

[1] Eli Noam, *Telecommunications in Europe* (New York, 1992), p. 43.

[2] *Town of Concord, Mass. v. Boston Edison Co.*, 915 F.2d 17, 21 (1st Cir. 1990) (citations omitted).

There is no good reason to subject VDT services to price-based regulation. The most common argument for price regulation -- the threat of monopolistic pricing -- simply cannot be made. To monopolize a market, a provider must have "the ability to restrict output or raise price over what would prevail in a competitive market, and maintain it over time."[3] Nobody alleges that we will have this ability in the video market. As CCTA acknowledges, "video dialtone service will be offered in a much more competitive environment than the market for most telephone services." (CCTA, p. 6.) So the incumbent providers must resort to a far less compelling argument for price controls -- that without them, competition will be too vigorous, with the new entrants pricing below their cost.

The predatory pricing allegation against us is exemplified by CCTA's allegation that we could "engage in cross-subsidization and predatory pricing by setting rates for [VDT] below their incremental costs and recover such costs from telephone ratepayers." (CCTA, p. 4. See also AT&T, p. 2; MCI, p. 3; CCTA, pp. 6-7; NCTA, p. 7.)[4] CCTA itself concedes the flaw in this allegation. "In theory," as CCTA says, "'[w]henever a set of rates is subject to a price cap, carriers have no incentive to shift costs into the basket because the cap does not move in response to cost changes.'" (CCTA,

---

3 *Competition, Rate Deregulation and the Commission's Policies Relating to the Provision of Cable Television Service,* 5 FCC Rcd 4962, 4968 n.19 (1990).

4 The "improper cross-subsidization" referred to in this proceeding is no different from "predatory pricing." A "price cap prevents the recoupment of past predatory rates; a price cap prevents prices from being raised in the current or future period to make up for losses incurred by rates set at predatorily low levels." *Policy and Rules Concerning Rates for Dominant Carriers,* CC Docket No. 87-313, *Supplemental Notice of Proposed Rulemaking,* released March 12, 1990, para. 243. Predatory pricing and improper cross-subsidization both require that a service be offered below its incremental cost with a predatory or improper intent, not merely below fully distributed cost or at a lower level of profitability than other services. See *MCI v. ATT*, 708 F2d 1081 (7th Cir. 1983) and *National Rural Telecom Ass'n v. FCC*, 988 F2d 175 (D.C. Cir. 1993).

p. 5.) As we pointed out in our Comments, this is no longer "theory". Carriers may now opt for price cap regulation without sharing and low-end adjustments. Carriers who do so have no ability to recover VDT costs by raising telephone rates.

We take note of two attacks on this claim, but neither holds water. First, the objection is made that as long as *state* price cap plans include sharing and low-end adjustments, the Commission cannot rely "exclusively on price caps to protect against unwarranted rate increases." (See CCTA, pp. 12-13.) We are unsure what relationship CCTA suggests there is between state price cap rules and interstate VDT prices. The separations rules are designed to preclude any interactions between intrastate telephone rates and interstate rates. The rules are not perfect, but the assumption that they could be manipulated without detection and without harm to ourselves to subsidize a specific interstate service is far-fetched.

Second, Ad Hoc claims that "[a]ssuming ... that LEC video/broadband investment comes to represent, say, 40% of total LEC net investment, ... anything less than an 8.8% X [productivity] factor applicable for non-video services would permit cross-subsidization of video/broadband by monopoly voice/narrowband to take place." (Ad Hoc, p. 16.) All that Ad Hoc is proving with this statement is that 5.3% is 60% of 8.8%. 5.3% is an update through 1990 of the Frenthrup-Uretzky and Spavins-Lande studies of interstate telephone productivity (excluding interexchange). It contains no video investments. There remains no evidence of the level of productivity to be expected of "video/broadband", still less that its productivity will be 5.3%, as Ad Hoc implicitly presumes.[5]

[5] There is also no basis, as Southwestern Bell states (p. 5), for averaging the 0% productivity factor for cable television with the 4.0% factor adopted in the LEC Price Cap Review order. This would be an explicitly arbitrary approach.

The predatory pricing argument against us carries no more weight than it would against any provider in a competitive market. And that is very little weight at all.

First, a checkpoint already exists. The antitrust laws, which have probably been more rigorously enforced in the telecommunications industry than in any other, already make below-cost pricing illegal. Given the indisputable harm that price controls in competitive markets do to consumer welfare, two regulators are not always better than one.

Second, the threat of predatory pricing, remote under ordinary circumstances,[6] is particularly remote here. When our VDT network is finished two coaxial cable networks will be in place. Even if our coaxial competitor went out of the business, its network would remain and could be reactivated by yet another firm in a very short time at a very low incremental cost. (This redundant coaxial network scenario doesn't even assume competition from wireless video systems, which in their short existence have achieved an astonishing growth rate.[7]) The Commission has recognized that predatory pricing "is rational only if the predator believes that it will be able to recoup its short-term

---

[6] "[I]n light of the difficulties of sustaining a predatory pricing scheme, the United States Supreme Court has observed that 'there is a consensus among commentators that predatory pricing schemes are rarely tried, and even more rarely successful'." *Competition in the Interstate Interexchange Marketplace,* CC Docket No. 90-132, *Notice of Proposed Rulemaking*, released April 13, 1990, para. 104 (quoting *Matsushita Electrical Industrial Co. v. Zenith Radio Corp.*, 475 U.S. 574, 589 (1986)).

[7] See letter to Kathleen Wallman, Chief, Common Carrier Bureau, from California Cable Television Ass'n, January 20, 1995, re: Applications of Pacific Bell for Authority under Section 214(a), p. 11: "According to reports cited by the FCC, 'initial demand for equipment necessary to receive DBS service has exceeded supply.' RCA shipped nearly 600,000 units in 1994 to receive DBS. Primestar expects 1 million units to be ordered by its distributors in 1995, and DirectTV expects 3 million subscribers by the second half of 1996. USSB is on a similar growth curve.... Pacific's revenue estimates remain unreasonably high. It totally ignores what will be a dynamic pricing situation with more than one competitor." We need not emphasize the conflict between such contentions, and the contentions of CCTA and others in this proceeding that the threat of predatory pricing justifies strict price controls on VDT.

losses with future monopoly profits."[8] The predator must be "reasonably sure that it will be able to drive existing competitors from the market [and that] new competitors will not replace the old ones once it raises its prices to monopoly levels in order to recoup its prior losses."[9] This will not be the case with VDT.

Finally, it is *incumbent providers*, not new entrants, who historically have represented the greatest threat to competition. This proceeding (in which incumbent providers argue for explicit barriers to entry) bears that out. The incumbents try, but do not quite succeed in turning the tables on this score. CCTA says, "the LECs are new entrants with powerful economic assets with every incentive to act like aggressive competitors -- i.e., they have every incentive to gain a competitive edge in the marketplace by whatever means it takes." (CCTA, p. 3.) Ad Hoc says: "As the 'new kid on the block' in the mass media marketplace, the LECs will necessarily seek to exercise every possible competitive advantage." (Ad Hoc, p. 8.) The "new kid on the block" principle is not one that we have been able to find in any textbook. There is just one relevant economic fact about new entrants: they have zero market share. That is a *disadvantage.*

MCI contends that incumbent providers are "cash-strapped". (MCI, p. 4.) What this means is anybody's guess. It cannot mean that cable companies lack access to capital. Time-Warner is flush with cash from US West; Cox, from Sprint. Perhaps it refers to cable companies' balance sheets. Cable companies do typically have higher debt ratios than telephone companies. That is not a disadvantage; it is a financial strategy. It is why cable network giants like TCI continue to take on new debt to buy more cable networks and invest in Primestar.[10]

---

8 *Id.*, para. 102.

9 *Id.*

10 See for example "That's Entertainment", *San Francisco Chronicle,* May 8, 1995, p. B2.

No purpose would be served by regulating the prices of VDT. Without sharing and low-end adjustments, we have no more ability or incentive to price our VDT services below incremental cost than any other competitive firm. There is an important corollary to this fact: not only does it argue for excluding VDT from price cap regulation, but it also removes any reason to oversee cost allocations or cost support.

While it may seem to do no harm to "scrutinize" VDT cost support, as CCTA suggests (p. 8), or even to require the LECs "to keep segregated records of all investments, revenues, and expenses associated with VDT ... establish new Part 36 rules ... [and] create a new Part 69 category," as MCI suggests (pp. 12-13), there are far better reasons *not* to do so. Ad Hoc says, "no other price cap service comes even close to displaying demand or supply characteristics similar to those of video dialtone service." (Ad Hoc, p. 8.) As we pointed out in our Comments, even LECs have sharply debated the potential demand for VDT services. NCTA says, "In any capital-intensive business, costs are very high in early years and lower in later years (as the investment is depreciated). A strict year-by-year cost analysis would lead to very high initial rates and very low rates in later years. This pricing approach makes no sense in the marketplace, and regulators do not require it of telephone companies."[11]

We made a similar point: the value of the VDT network will increase exponentially with each new subscriber. From a public policy standpoint, the best pricing strategy for VDT services may therefore be a low initial price to encourage connection, then a rising price to reflect the increasing value of the network as connection becomes more widespread. Conventional price regulation would

---

[11] Ex Parte of NCTA, MM Docket No. 93-215, filed March 10, 1995.

frustrate such a policy. CCTA says, "If initial video dialtone rates are set below cost, the price cap mechanism will not correct -- and indeed may exacerbate -- this anticompetitive pricing." (CCTA, p. 9.) But the converse is also true. If VDT rates are required to be set at anticompetitive levels that discourage VDT use, price cap regulation "will not correct ... indeed may exacerbate" it. Consumers will pay billions in higher rates or simply lost alternatives, as they did because of the long delay in the introduction of cellular service.[12]

In the absence of sharing and low-end adjustments, there is no compelling reason for price controls on VDT. Carriers electing the no-sharing option under price caps should be permitted to offer all VDT services outside of price caps. Carriers electing the sharing option should be given far more flexibility in setting and changing VDT rates than price cap services typically enjoy. VDT services should be held outside of price cap regulation until demand for them is known; they should not be subject to a productivity factor; and they should not be subject to price bands or other price controls that may prevent us from responding to market demands. The Commission will have risked

[12] Cellular technologies were introduced in the 1940s, and experimental working models were in place as early as 1962. Although spectrum was reallocated in 1970 to make room for cellular services, the first experimental license was not granted by the FCC until 1977, and other commercial licenses were not granted until the early 1980s. As three economists have argued, "had the FCC proceeded directly to licensing from its 1970 allocation decision, cellular licenses could have been granted as early as 1972 and systems could have become operational in 1973, a decade earlier than they were in reality." They estimate this regulatory delay cost the U.S. economy $86 billion by 1983, when cellular licensing began. Jeffrey H. Rohlfs, Charles L. Jackson, and Tracey E. Kelly, *Estimate of the Loss to the United States Caused by the FCC's Delay in Licensing Cellular Telecommunications* (Washington, D.C.: National Economic Research Associates, Inc., November 8, 1991), p. 4.

nothing by doing this. It would retain full Title II jurisdiction over VDT services, including among other things the authority to prescribe new prices at any time.

Respectfully submitted,

PACIFIC BELL

LUCILLE M. MATES
JOHN W. BOGY

140 New Montgomery Street, Rm. 1530A
San Francisco, California 94105
(415) 542-7634

JAMES L. WURTZ
MARGARET E. GARBER

1275 Pennsylvania Avenue, N.W.
Washington, D.C. 20004
(202) 383-6472

Its Attorneys

Date: May 17, 1995

## CERTIFICATE OF SERVICE

I, Chuck A. Nordstrom, hereby certify that a copy of the foregoing **"REPLY COMMENTS OF PACIFIC BELL"** regarding Docket No. 94-1 was served by United States first-class mail, postage prepaid, on this 17th day of May, 1995 to the parties named on the attached service list.

Chuck A. Nordstrom

Chuck A. Nordstrom

PACIFIC BELL
140 New Montgomery Street
San Francisco, CA 94105

**SERVICE LIST- DOCKET NO. 94-1**

Mary McDermott
Linda Kent
Charles D. Cosson
Attorneys for UNITED STATES
TELEPHONE ASSOCIATION
1401 H Street, N. W.
Suite 600
Washington, D. C. 20005

Adelle Swanson
Administrative Librarian
RIVERDALE PUBLIC
LIBRARY DISTRICT
208 W. 144th Street
Riverdale, IL 60627

Michael Hydock
Executive Staff Member
Federal Regulatory
MCI TELECOMMUNICTIONS
CORPORATION
1801 Pennsylvania Ave., N. W.
Washington, D. C. 20006

Robert M. Lynch
Durward D. Dupre
Thomas A. Pajda
Anthony K. Conroy
Attorneys for SOUTHWESTERN
BELL TELEPHONE COMPANY
One Bell Center, Suite 3520
St. Louis, Missouri 63101

James T. Hannon
Sharon L. Naylor
Attorneys for U S WEST
COMMUNICATIONS, INC.
1020 19th Street, N. W.
Suite 700
Washington, D. C. 20036

Michael E. Glover
Edward Shakin
Attorneys for
BELL ATLANTIC
1320 North Court House Road
Arlington, VA 22201

Alan J. Gardner
Jerry Yanowitz
Jeffrey Sinsheimer
CALIFORNIA CABLE
TELEVISION ASSOCIATION
4341 Piedmont Avenue
Oakland, California 94611

Frank W. Lloyd
Donna N. Lampert
James J. Valentino
MINTZ, LEVIN, COHN, FERRIS,
GLOVSKY AND POPEO, P.C.
Attorneys for the CALIFORNIA
CABLE TELEVISION ASSOC.
701 Pennsylvania Ave., N. W.
Suite 900
Washington, D. C. 20004

M. Robert Sutherland
Richard M. Sbaratta
Attorneys for BELLSOUTH
TELECOMMUNICATIONS, INC.
4300 Southern Bell Center
675 West Peachtree Street, N. E.
Atlanta, Georgia 30375

Jay C. Keithley
Attorney for UNITED AND
CENTRAL TELEPHONE
COMPANIES
1850 M Street, N. W.
Suite 1100
Washington, D. C. 20036

Daniel L. Brenner
Neal M. Goldberg
David L. Nicoll
Attorneys for the NATIONAL CABLE
TELEVISION ASSOCIATION, INC.
1724 Massachusetts Ave., N. W.
Washington, D. C. 20036

Barry S. Abrams
Campbell L. Ayling
Attorneys for the NYNEX
TELEPHONE COMPANIES
1111 Westchester Avenue
White Plains, NY 10604

James S. Blaszak, Esq.
LEVINE, BLASZAK, BLOCK
& BOOTHBY
Attorney for AD HOC TELECOM-
MUNICATIONS USERS COMMITTEE
1300 Connecticut Avenue, N. W.
Suite 500
Washington, D. C. 20036

Mark C. Rosenbum
Robert J. McKee
Seth S. Gross
Attorneys for
AT&T CORP.
295 North Maple Avenue, Room 3244J1
Basking Ridge, New Jersey 07920

Michael J. Shortley, III
Attorney for ROCHESTER
TELEPHONE CORP.
180 South Clinton Avenue
Rochester, New York 14646

Barbara O'Connor
Director
Institute for the Study of Politics and Media
CALIFORNIA STATE UNIVERSITY
6000 J Street
Sacramento, CA 95819

Gail L. Polivy
Attorney for GTE
SERVICE CORP.
1850 M Street, N. W. Suite 1200
Washington, D. C. 20036

Richard McKenna, HQE03J36
Attorney for GTE
SERVICE CORP.
P. O. Box 152092
Irving, TX 75015-2092

Werner K. Hartenberger
Leonard J. Kennedy
Laura H. Phillips
DOW, LOHNES & ALBERTSON
Attorneys for COX ENTERPRISES, INC.
1255 Twenty-Third Street, N. W.
Suite 500
Washington, D. C. 20037

Tenley A. Carp
Assistant General Counsel
Personal Property Division
GENERAL SERVICES
ADMINISTRATION
18th & F Streets, N. W.
Room 4002
Washington, D. C. 20405

Coral S. Swanson
Chair
Library Development and
Legislation Committee
WISCONSIN LIBRARY
ASSOCIATION, INC.
4785 Haven Road
Madison, WI 53704